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ABSTRACT

When determining a school system insurance program, the school board should first set a general insurance management policy statement for administrators to carry out. Next an overview of all the system operations must be made. The risks must then be quantified in terms of all potential financial loss. When designing an insurance program, the district ought to incorporate loss prevention, avoidance of risk, assumption of risk through deductibles, self-insurance, and insurance. It is wise to figure potential losses per occurrence and self-insure the smaller losses. For larger losses, insure to the full replacement value and eliminate as many exclusions as possible. If risk is assumed through deductibles, the deductible is usually paid from reserve funds. When determining the amount of deductible to maintain, it should be remembered that increased premiums necessitated by a lower deductible will add up over a long period of time. It is acceptable to take bids when choosing an insurance company, as long as bidding does not interfere with the long-term nature of the insurance management program. When choosing an employee benefits program, it must be remembered that although a small deductible may represent considerable savings to the system, it may not represent savings to the employee. (Author/JM)

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SELF INSURANCE AND OTHER TRENDS IN INSURANCE MANAGEMENT

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NSBA CLINIC A-14
April 21, 1979

Our Clinic topic is self-insurance and other trends in insurance management, which is apt because you can't really treat self-insurance without reference to other trends and to the techniques of insurance management.

What I propose to do is deal first with general concepts of insurance management, and then with self-insurance as it relates to the over-all insurance management program. The initial portion of my remarks will deal with insurance management in the area of property and casualty insurance, which is my primary interest. The concepts, however, are the same in the employee benefits, and I have some supplementary remarks on that.

CONCEPTS OF INSURANCE MANAGEMENT

The concepts of insurance management are no different than other types of management. If you are a believer in management by objectives, as I am, then insurance management becomes a series of steps, as follows:

Define the objectives

Get the facts

Analyze the facts

Act on the facts

Reach the objectives

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While most of use would say the day-to-day management of insurance program lies in the last step, reaching the objective, this is not entirely true. Insurance is an adjunct to or response to the normal operations of the school system, and the "facts" of the school system relative to insurance keep changing so that the fact gathering and fact analysis phases of insurance management are continuous.

Many people would question how formal a definition of objective is required in an insurance management program. I believe that the govering board should establish a policy statement for the administrators to carry out, but it should be limited to policy and not day-to-day administration. Therefore, the policy should be stated in fairly general terms but should include the financial parameters to give the administrator leeway in adopting reasonable levels of risk retention (or self-insurance). One rather pragmatic reason for this approach, in addition to the fact that it is simply good management practice, it is that many of the so-called school board liability insurance policies have an exclusion for claims arising out of alleged failure to carry proper insurance. While a policy statement by the school board would be no guarantee against claims of this sort, it seems to me that it would at least help if you could point to a carefully thought-out and formally adopted policy statement governing insurance matters.

While the policy statement covers a number of things, the item we are most concerned with in this discussion deals with the financial aspects of insurance management (or "risk management"). Our major objective is to have adequate financial resources available to us in the event of certain clearly specified contingencies, and we wish to have these financial resources available at the least cost to us.

GETTING THE FACTS

Getting the facts is time consuming and involves physical overview of the system operations as well as review of all pertinent documents and plans. A very useful tool, almost an essential tool, is some sort of checklist. There are a number of these commercially available. A word of caution, however, is that a fact should not be overlooked simply because it is not specifically covered on a checklist.

ANALYZING THE FACTS

The analysis of the facts involves quantifying the risks in terms of potential financial loss to the school system. This involves appraisals of property values, the estimation of potential time element losses, and determination of accident probability and the valuation of potential catastrophe losses. In connection with property values, one of the more difficult values to determine are furniture and fixtures and items such as library books. I find this is an area often overlooked or seriously under-estimated.

ACT ON THE FACTS

Once you have gathered the facts and analyzed them, the next step is to design an insurance program to meet your needs. (I continue to use "insurance program" although insurance is generally the last alternative selected).

When you design an insurance program you consider:

Loss Prevention

Avoidance of Risk

Assumption of Risk through deductibles

Self-insurance

Insurance.

It is no accident that insurance is that last item to be considered because, in the long run, it is the most expensive. I think we realize that for an insurance company to stay solvent it must collect enough premiums to pay not only the claims but also its overhead expense. Self-insurance, therefore, would save at least the overhead expense. Insurance companies do, of course, provide services to their clients in addition to insurance itself and these services - loss adjustment, loss prevention, advisory services, etc., have to be obtained elsewhere if the insurance company is not providing it. Even so, self-insurance would save at least the profit margin and premium tax elements of insurance costs.

If you self-insure, one basic commitment you must make is acceptance of a fluctuation in cost, and this means that your school system must have enough flexibility in its budget to absorb this fluctuation. One of the advantages of insurance is that it substitutes a certain cost for an uncertain cost and this has some benefit in establishing a budget. (On the other hand, insurance costs are not as fixed as they may appear since most insurance policies have a cancellation provision in them. I don't know if you have had this happen to you, but if during the policy term the losses exceed insurance company expectations - in particular if the number of claims exceed the insurance company's expectations, the company may either cancel the insurance, requiring you to obtain new and higher priced insurance, or it may increase the premium. Therefore, the cost is not quite as fixed as it would appear on the surface of the contract.)

A second point to consider in evaluating self-insurance is the time the money will be needed in response to a contingency. Different losses require the availability of funds with varying degrees of promptness. A fire loss to a building, for instance, must be promptly repaired so there is a relatively quick need for funds. A time element loss requires even more prompt availability of funds. A workers compensation loss, on the other hand, may require funds in periodic payments over a period of years so that while the ultimate cost of the loss is large, the money is not immediately needed. A large liability claim presents still a different situation. There is usually a long lead time before the final

amount of the claim is known so that there is some time for the school sytem to accumulate the funds.

Finally, in considering self-insurance you need to consider the aggregate potential cost of all losses which will be assumed. All insurance policies contain exclusions, so any risk excluded by the policy is automatically retained or assumed by the school system. In addition, on certain types of property policies, not all of the property is insured. For instance, if you are insuring subject to an 80% co-insurance clause and have insured your buildings to 80% of their value, you have assumed the risk of the last 20% of the loss if there is a total loss. If you are insuring on an "actual cash value" basis as opposed to a "replacement cost" basis, then you have assumed the depreciation cost as well. In addition, certain types of property may be excluded from the valuation, such as below ground foundations. These may not be reuseable and certainly are susceptible to damage from certain types of perils so here again you have assumed a portion of the loss.

Following the same rationale, you assume the risk of any claim in excess of the liability limits you are carrying. If you have a liability policy with $300,000 limit per occurrence, and a suit is successfully pursued against you which has an ultimate cost of $500,000, then you have assumed the $200,000 difference.

Another consideration lies in what aggregate losses might be assumed in the event of a serious natural disaster. For instance, you may elect not to insure plate glass because the loss in any one building is insignificant. What is the situation, however, if a windstorm strikes and breaks the glass out of many buildings? The loss, then, is not insignificant. Similarly, you might have a relatively small deductible on property insurance. Does this deductible apply per location or per occurrence? If it applies per location a windstorm may damage several buildings to the amount of the deductible at each location, and in that case you would have a cumulative loss which would be significant. A third example of this type that is relatively common involves automobile fleets. Many school systems do not insure their fleets for any physical damage coverage because they operate a large number of units and feel that they can absorb the cost of individual losses to each motor vehicle. However, all the motor vehicles are freqently parked at the same location. In that event, they are all exposed to a single loss from windstorm, fire, explosion, or similar perils and the loss could rapidly multiply beyond the planned-for costs.

As a general rule, then, in considering self-insurance I suggest that you state your limits of self-insurance in terms of an aggregate loss per occurrence, and self-insure the smaller losses. For insurance purchased above those amounts, have as many of the exclusions as possible eliminated, and insure to the full replace-

ment value of property. If you intend to self-insure the more frequent loss, which is the one you should self-insure, you do not want to inadequately insure the large infrequent loss.

I'd like to make a point here about the term "deductible", or "assumption of risk", and "self-insurance". I have used these inter-changeably but in fact as I view it self-insurance is for predictable losses that you expect to fund out of operating revenue; while the "deductible" is for relatively infrequent losses which would generally be paid from reserves or some other source of funds. You can, however, convert loss projections from the "unpredictable" to the 'predictable" by stretching out the time period of your analysis. Losses may be unpredictable say in a term of one year but if you extend that to five years you will improve the predictablility. Therefore, where it is possible I would suggest building your insurance program around longer term predictions. Self-insurance does require a long-term commitment.

Of course, no matter how long a term you use, you can never be 100% certain.

BIDDING

A question is often asked about whether bids should be taken on insurance, or not. This is a matter of Board policy and while my personal preference would be "informed negotiation", I have no real opposition to bidding as long as it does not interfere with the long term on-going nature of your insurance management program.

Whether or not you elect to bid, you should prepare specifications on each policy renewal, because the specifications will serve you well in terms of analyzing what cost should be. If you intend to negotiate the cost you need to have some idea, yourself, of the proper price for the insurance.

If you do elect to bid, then in addition to the exposure and loss histories that are included, and a description of coverages that are desired, you should include clear stipulations as to the services you wish from the insurance company, and broker or agent. Theoretically, at least, the losses should be the same no matter what insurance company is involved so any cost differential should hinge upon services that are to be provided; and you will need to make sure you are going to get the services you need. It is also only fair to the insurance company and the broker or agent that they know what is expected of them so that they can properly price their services.

Finally, a question is often raised that there is very little savings for deductibles or smaller retentions. For instance, the premium credit for a $5,000 property insurance deductible may be 20% and for a $10,000 deductible only 22%. Many people then decide that the savings for higher deductible is not worth additional risk. This may be a valid analysis of the situation, but you should keep in mind, first, the long term nature of the insurance program - a decision to adopt self-insurance is a long-term commitment. Second, consider that in insurance pricing the deductible has a two-fold effect. The first effect is of course the actual premium

credit, but there is a secondary effect in that losses that you assume are not charged against you in experience rating. There may be an additional credit to you in the prospective rating of the policy as a result of retaining part of the risk through a deductible.

EMPLOYEE BENEFITS

I am going to close with one very brief comment on employee benefits. I think, in general, the same steps can be followed in working on employee benefits program as on property and casualty insurance. There is, however, a major consideration that is not present in considering property and casualty self-insurance. When self-insurance and deductibles are considered with regard to employee benefits, there is a question of the individual income tax implications. A small deductible may represent considerable savings to School System, but it may not represent considerable savings to the School System employee. This is particularly true if the employee is paying the cost of the deductible, since in general terms medical expenses which do not exceed 3% of adjusted gross income are not deductible from income for tax purposes. Therefore, the employee is paying that expense with "after-tax" dollars whereas if he had his first dollar coverage on employee benefits basis, and if the system is paying for this cost., the employee is, in effect, receiving additional income.

If there are questions I'll be please to answer them.

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STEPS IN

DESIGNING AN INSURANCE MANAGEMENT PROGRAM

1. **Define Objectives**

2. **Get the FACTS ("Risk Discovery")**

3. **Analyze the FACTS ("Risk Evaluation")**

4. **Act on the FACTS (consider alternatives)**

5. **Reach Objectives**

Sample Policy*

INSURANCE MANAGEMENT

The insurance program of the _____ School System shall be obtained at the most economical cost consistent with needed services and with the principles set forth herein:

1. Maintain safe facilities for the use of students, the public, and system personnel.

2. Adopt standards for a safe place to work and strive toward meeting the requirements of the Federal Occupational Safety and Health Act, and related State acts.

3. Maintain insurance coverage, in sound insurance companies providing suitable service, to comply with all statutory requirements.

4. Maintain insurance coverage, in sound insurance companies providing suitable service, to comply with all creditor or property lending agency requirements.

5. Self-insure or retain all risks, other than those in 3 and 4 above, for which a single loss will not exceed ⅛ of 1 per cent of tax receipts, and for which it can be reasonably predicted that aggregate annual losses will not exceed 1 per cent of tax receipts, providing that there are appropriate concessions as to insurance premium and coverage.

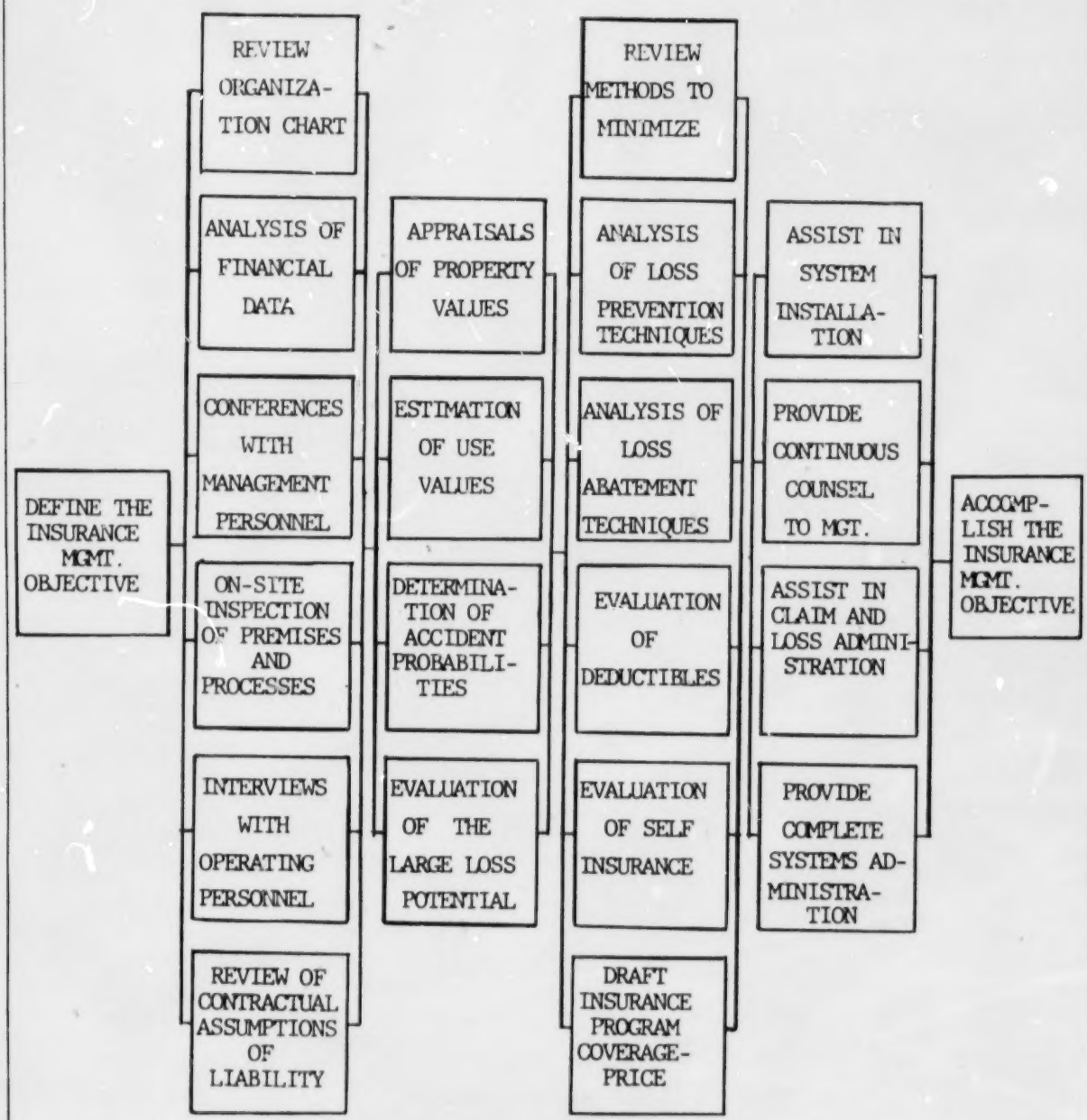
6. Insure all remaining risks in sound insurance companies providing suitable service and coverage. Coverage should contain as few exclusions as possible, appropriate to cost. Assets should be insured to full replacement cost. Liability coverage limits, where purchased, should be no more than $1,000,000 for a single occurrence.

7. The total cost to the School System of the Risk Management Program, including amortization of loss prevention and loss abatement installations, should not exceed 2.0 per cent of tax revenue.

Annual reports will be made to the Board of Education on the functioning of the insurance program.

*The Sample statement is purely an example, and does not necessarily include all items necessary for each system.

THE SYSTEMS APPROACH TO INSURANCE MANAGEMENT


OVERVIEW
MEASUREMENT
DESIGN
ADMINISTRATION
DEFINE THE INSURANCE MGMT. OBJECTIVE
REVIEW ORGANIZATION CHART
ANALYSIS OF FINANCIAL DATA
CONFERENCES WITH MANAGEMENT PERSONNEL
ON-SITE INSPECTION OF PREMISES AND PROCESSES
INTERVIEWS WITH OPERATING PERSONNEL
REVIEW OF CONTRACTUAL ASSUMPTIONS OF LIABILITY
APPRAISALS OF PROPERTY VALUES
ESTIMATION OF USE VALUES
DETERMINATION OF ACCIDENT PROBABILITIES
EVALUATION OF THE LARGE LOSS POTENTIAL
REVIEW METHODS TO MINIMIZE
ANALYSIS OF LOSS PREVENTION TECHNIQUES
ANALYSIS OF LOSS ABATEMENT TECHNIQUES
EVALUATION OF DEDUCTIBLES
EVALUATION OF SELF INSURANCE
DRAFT INSURANCE PROGRAM COVERAGE-PRICE
ASSIST IN SYSTEM INSTALLATION
PROVIDE CONTINUOUS COUNSEL TO MGT.
ASSIST IN CLAIM AND LOSS ADMINISTRATION
PROVIDE COMPLETE SYSTEMS ADMINISTRATION
ACCOMPLISH THE INSURANCE MGMT. OBJECTIVE

COMPLETE PLANNING FOR CONTINGENCIES

ILLUSTRATION OF RETAINED LOSS

Shaded area illustrates amount of replacement cost of building uninsured in event of total loss to building covered for 80% of actual cash value.